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ABSTRACT

This booklet contains the report from the House of Representatives Committee on Ways and Means on the amendment to the Internal Revenue Code which would allow taxpayers an income tax deduction for the business use of any part of their residence for day care services, whether or not that part is exclusively used for day care. Included in the report are: (1) a summary of the amendment; (2) a discussion of the present law, a statement of reasons for change, and an explanation of the new provision; (3) a statement of the effect of the bill on the budget; (4) the vote of the committee in reporting the bill; (5) committee findings on related matters required to be discussed under house rules; (6) the text of changes in existing law made by the bill as reported; and (7) the additional views of Hon. Ken Holland. (JMB)

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95TH CONGRESS
1st Session
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REPORT
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U S DEPARTMENT OF HEALTH, EDUCATION & WELFARE
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BUSINESS USE OF RESIDENCE FOR DAY CARE SERVICES

APRIL 5, 1977.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany H.R. 3340]

The Committee on Ways and Means to whom was referred the bill (H.R. 3340) to amend the Internal Revenue Code of 1954 to allow a deduction for expenses allocable to the use of any portion of a dwelling unit in the trade or business of providing day care services whether or not such portion is exclusively used in such trade or business, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment (stated in terms of the page and line numbers of the introduced bill) is as follows:

Page 2, strike out line 1 and all that follows down through line 6 and insert:

"(4) USE IN PROVIDING DAY CARE SERVICES.—

"(A) IN GENERAL.—Subsection (a) shall not apply to any item to the extent that such item is allocable to the use of any portion of the dwelling unit on a regular basis in the taxpayer's trade or business of providing day care services to individuals.

"(B) LICENSING, ETC., REQUIREMENT.—Subparagraph (A) shall apply to items accruing for a period only if the owner or operator of the trade or business referred to in subparagraph (A)—

"(i) has applied for (and such application has not been rejected),

"(ii) has been granted (and such granting has not been revoked), or

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"(iii) is exempt from having,
a license, certification, registration, or approval as a day care center or as a family or group day care home under the provisions of any applicable State law. This subparagraph shall apply only to items accruing in periods beginning on or after the first day of the first month which begins more than 90 days after the date of the enactment of this subparagraph."

I. SUMMARY

The bill provides an exception to the exclusive use test enacted in the Tax Reform Act of 1976 for the deduction of expenses allocable to the use of any portion of a residence in the trade or business of providing day care services to individuals. The exception from the exclusive use test applies only if the taxpayer has complied with applicable State law for the licensing, certification, registration, or approval of the residence for use as a day care center or as a family or group day care home. The licensing or other requirement does not apply to day care services which are exempt from licensing, etc. under the State law or where a State does not have a licensing or other requirement. In order to provide a transitional period, the licensing, etc. requirement applies only to expenses accrued by day care services on or after the first day of the first month beginning more than 90 days after enactment of the bill. Since the bill applies from the effective date of the Tax Reform Act of 1976 (that is, from the beginning of 1976), the licensing or other requirement does not apply for 1976.

The bill provides a maximum amount which may be deducted with respect to day care services. This limitation is the gross income from the day care services less the allocable portion of the other expenses of a residence (property taxes, mortgages interest, etc.) which are deductible in any event.

(3)

II. GENERAL STATEMENT

Present law

Under the Internal Revenue Code, no deductions are allowed for personal, living, and family expenses except as expressly allowed (sec. 262). Generally, under this provision, expenses and losses attributable to a dwelling which is occupied by a taxpayer as his or her personal residence are not deductible. However, deductions for interest, certain taxes, and casualty losses attributable to a personal residence are expressly allowed under other provisions of the tax law (secs. 163, 164 and 165). Prior to the Tax Reform Act of 1976, if a portion of the residence was used in the taxpayer's trade or business or for the production of income, a deduction was allowed for an allocable portion of the expenses incurred in maintaining such personal residence.

The Tax Reform Act of 1976 added a new section to the Code (sec. 280A) which provides, in part, that no deductions shall be allowed with respect to a dwelling unit which is used by the taxpayer as a residence, unless specifically excepted from this new section and otherwise allowable. This provision applies to individuals, trusts, estates, partnerships, and electing small business corporations. It does not apply to a corporation (other than an electing small business corporation).

The general disallowance provision, however, does not apply with respect to certain expenses which are otherwise allowable as deductions; for example, the deductions allowable for interest (sec. 163), certain taxes (sec. 164) and casualty losses (sec. 165) may still be claimed as deductions without regard to their connection with the taxpayer's trade or business or income producing activities.

In the case of a taxpayer who exclusively uses a portion of a dwelling unit on a regular basis as his principal place of business, as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or in the case of a separate structure which is not attached to the dwelling, in connection with the taxpayer's trade or business, an allocable portion of ordinary and necessary trade or business expenses paid or incurred in connection with such trade or business use will be allowed as a deduction. However, the amount of the deduction is subject to a limitation discussed below. In addition, in the case of an employee, a deduction is allowable only if the business use is for the convenience of the employer.

Exclusive use of a portion of a taxpayer's dwelling unit means that the taxpayer must use a specific part of a dwelling unit solely for the purpose of carrying on his trade or business. The use of a portion of a dwelling unit both for personal purposes and for the carrying on of a trade or business does not meet the exclusive use test. Thus, for example, a taxpayer who uses a den in his dwelling unit to write legal briefs, prepare tax returns, or engage in similar activities, as well as for personal purposes, will be denied a deduction for the expenses paid

or incurred in connection with the use of the residence which are allocable to these activities.

Under the Act, an exception to the exclusive use test is provided in the case of a taxpayer whose trade or business is selling products at retail or wholesale and whose dwelling unit is the sole fixed location of such trade or business. Under this exception, the ordinary and necessary expenses allocable to space within a dwelling unit which is used as a storage unit for inventory will not be disallowed. However, the space must be used on a regular basis and must be a separately identifiable space suitable for storage.

In addition to the exclusive use test, the Act requires that the portion of the residence used for trade or business purposes must be used by the taxpayer on a regular basis in order for the allocable portion of the expenses to be deductible. Expenses attributable to incidental or occasional trade or business use of an exclusive portion of a dwelling unit are not deductible.

The provision does not permit a deduction for any portion of expenses paid or incurred with respect to the use of a dwelling unit which is used by the taxpayer both as a residence and in connection with income producing activities (sec. 212). For example, no deduction is allowed if a taxpayer who is not in the trade or business of making investments uses a portion of his residence (exclusively and on a regular basis) to read financial periodicals and reports, clip bond coupons and perform similar activities because the activity is not a trade or business.

In the case of an employee, a deduction for the portion of the ordinary and necessary business expenses attributable to the use of a residence which are paid or incurred in connection with the performance of services as an employee is allowable only if, in addition to satisfying the exclusive and regular use tests, the use is for the convenience of his employer. If the use is merely appropriate and helpful, no deduction attributable to such use is allowable.

The Act also provides an overall limitation on the amount of deductions that a taxpayer may take for the business use of the home. The allowable deductions attributable to the use of a residence for trade or business purposes may not exceed the amount of the gross income derived from the use of the residence for that trade or business reduced by the deductions which are allowed without regard to their connection with the taxpayer's trade or business (e.g., interest and taxes). In the case where gross income is derived both from the use of the residence and from the use of facilities other than the residence, a reasonable allocation (based on the facts and circumstances of each case) must be made to determine that portion of the gross income derived from the use of the residence. With respect to the deductions which are allocable to the trade or business use of the residence, deductions allowable without regard to whether the activity is a trade or business are to be deducted first. Any remaining gross income may then be reduced (but not below zero) by the remaining allowable deductions which are allocable to such use.

In determining the deductible amount attributable to the business use of the home, the general rule is that any reasonable method of allocation may be used. In all cases involving the dual use of a home, the

allocation of expenses attributable to the portion of the residence used for business purposes will take into account the space used for those purposes, e.g., a percentage of the expenses based on the square feet of that portion compared to the total square feet of the residence. In addition, a further allocation based on time of use is required when the portion of the residence is not exclusively used for business purposes. In Rev. Rul. 62–180, 1962–2 C.B. 52, 54, the Internal Revenue Service took the position that, after allocating expenses attributable to a den used for business and personal purposes on the basis of space, a further allocation must be made on the basis of time of use to reflect the dual use. For purposes of the latter allocation, the Service ruled that the allocation should be made on the basis of availability for use rather than actual use, i.e., the ratio of time actually used for business purposes to the total time it is available for all uses. However, in *George W. Gino*, 60 T.C. 304, 314 (1973) (followed in *Lena M. Anderson*, T.C. Memo. 1974–49)), the Tax Court held that such expenses should be allocated on the basis of actual business use as compared with actual total use. The issue concerning the allocation of expenses for a portion of a residence used for business and personal purposes is no longer relevant where the exclusive use test applies.

Reasons for change

It has been pointed out that the exclusive use test will rarely be satisfied in the case of the use of a personal residence to provide certain day care services. Typically, the portion of the residence used to provide these services will also be used for personal purposes. In these cases, it is not practicable to cordon off a portion of the residence to be devoted exclusively to providing day care services. However, where a portion of the residence is used for personal purposes and day care services, the committee believes that this type of business activity in the residence will ordinarily result in incurring incremental expenses attributable to the residence beyond those which would have been incurred if the residence had been used solely for personal purposes. For example, it has been pointed out that this type of business activity will usually result in additional wear and tear on the residence which would be reflected in additional depreciation in the value of a home owned by the taxpayer providing the services, additional repair and maintenance expenses, and additional utilities expenses.

The committee believes that the exception should apply only if the day care services are in compliance with applicable State law (if any) for the licensing, certification, registration or approval of day care services.

Explanation of provision

The bill provides an exception from the general disallowance rule and the exclusive use test for expenses allocable to the use of any portion of a residence on a regular basis in the taxpayer's trade or business of providing day care services to individuals. The exception does not apply where the taxpayer provides day care services occasionally or on an incidental basis. To be eligible for the exception, the day care services have to be provided for compensation on a regular basis. In addition, the day care services have to satisfy certain licensing, etc., requirements described below.

For purposes of this exception, qualifying day care services consist of services performed primarily as a custodial service for children, physically and mentally handicapped individuals, and the elderly. The exception does not apply where the services performed in the home are primarily educational or instructional in nature. For example, this exception to the exclusive use test would not apply to a portion of a residence used to give musical instruction to students. However, the exception would apply if the services are primarily custodial and the educational, developmental, or enrichment activities are only incidental to the custodial services. Generally, the determination of school age is to be considered incidental to the custodial services, would depend on the facts and circumstances of the particular case. However, for this purpose, educational instruction to children of nursery school age are to be considered incidental to the custodial services. Further, educational instruction to children of kindergarten age would ordinarily be considered incidental to the custodial services if the instruction is not in lieu of public instruction under a State compulsory education requirement. In addition, enrichment instruction in arts and crafts to children, handicapped individuals, or the elderly would ordinarily be considered incidental to the custodial services rendered.

The expenses allocable to the portion of the residence used for providing day care services are to be determined by taking into account, on the basis of any reasonable method of recordkeeping, the space used for providing the day care services and the time that portion is used for providing these services. First, the expenses attributable to the residence (depreciation, or rent, insurance, utilities, and maintenance) are to be allocated on the basis of space, e.g., the expenses attributable to the portion used for day care services would be determined on the basis of the floor space for that portion as compared to the floor space for the entire residence. Second, the amount of the expenses allocable to the space used for providing day care services are then to be allocated on the basis of time of use for business purposes and personal purposes. This allocation is to be made on the basis of the time of use for business purposes as compared to the time of total use.

The deductible business expenses are to be limited to the amount by which the gross income from day care services exceeds the allocable portion of the property taxes, mortgage interest, etc., which are deductible in any event. For this purpose, gross income would consist only of the fees and compensation included in gross income which are received for day care services. It would not include any amounts received by the taxpayer for alimony or child support payments. For purposes of applying the limitation, expenses which do not result in an adjustment to basis would be taken into account first. Expenses, such as depreciation, which result in an adjustment to basis would then be taken into account to the extent that gross income exceeds the other allocable deductions.

After the expiration of a transitional period, the exception to the exclusive use test for day care services applies only if the taxpayer has complied with any applicable State law for the licensing, certification, registration, or approval of the residence for use as a day care center or as a family or group day care home. This requirement applies only to expenses accruing for a period beginning on or after

the first day of the first month which begins more than 90 days after the bill is enacted. Thus, the licensing, etc. requirement will not apply to 1976 and will only apply to a portion of 1977.

This requirement would be satisfied if the owner or operator of the day care business had applied for, or had been granted, any required license, certification, registration, or approval. Expenses incurred after an application is rejected would not be deductible under the provision. However, expenses incurred after the deficiencies or grounds for rejection are corrected or removed would be taken into account under the new provision if the application is reinstated, resubmitted, or approved. Similarly, expenses incurred after a license, certification, registration, or approval is revoked would not be deductible under the provision. The expenses incurred after the deficiencies or grounds for revocation are corrected or removed would be taken into account under the new provision if the owner or operator is granted or reapplies for reinstatement of a license, certification, registration or approval.

The licensing compliance requirement does not apply to a day care service which is exempt under State law (including the laws of the District of Columbia, if applicable) from licensing, certification, registration, or approval. Of course, the licensing compliance requirement has no application, if the applicable State law imposes no licensing, certification, registration or approval requirement.

Effective date

The bill is to apply to taxable years beginning after December 31, 1975. The licensing requirements (discussed above) apply only to expenses accruing for a period beginning on or after the first day of the first month which begins more than 90 days after the bill is enacted.

III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

Budget effects

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made relative to the effect on the budget of this bill, H.R. 3340, as amended. The committee estimates that the budget effect of this bill, as amended, is to reduce receipts by $40 million in fiscal year 1977, $30 million in fiscal 1978 and $25 million in fiscal 1979 and $26 million in each of fiscal years 1980 and 1981.

The Treasury Department agrees with this statement.

Vote of the committee

In compliance with clause 2(l)(2)(B) of rule XI of the Rules of the House of Representatives, the following statement is made relative to the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 3340, as amended, was ordered favorably reported by a voice vote.

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IV. OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clauses 2(l)(3) and 2(l)(4) of rule XI of the Rules of the House of Representatives, the following statements are made with respect to the committee action on H.R. 3340, as amended.

Oversight findings

With regard to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the committee advises that in its review of the general effects of the Tax Reform of 1976, the committee concluded that it is appropriate to modify the income tax rules for the deductibility of expenses allocable to the business use of a residence enacted in the Tax Reform Act of 1976, with respect to the use of providing day care services to individuals.

New budget authority and tax expenditures

In compliance with subdivision (B) of clause 2(l)(3), and after consultation with the Director of the Congressional Budget Office, the committee states that the changes made by this bill involves no new budget authority or new or increased tax expenditures.

Consultation with Congressional Budget Office on budget estimates

With respect to subdivision (C) of clause 2(l)(3), the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated in part III of this report) and agrees with the methodology used and the resulting dollar estimated for those items.

Oversight by Committee on Government Operations

With respect to subdivision (D) of clause 2(l)(3), the committee advises that no oversight findings or recommendations have been made by the Committee on Government Operations regarding the subject matter contained in this bill.

Inflationary impact

In compliance with clause 2(l)(4), the committee states that the enactment of this bill is not expected to have an inflationary impact on prices and costs in the operation of the national economy.

(10)

V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE OF 1954

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Subtitle A—Income Taxes

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CHAPTER 1—NORMAL TAXES AND SURTAXES

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Subchapter B—Computation of Taxable Income

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PART IX—ITEMS NOT DEDUCTIBLE

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SEC. 280A. DISALLOWANCE OF CERTAIN EXPENSES IN CONNECTION WITH BUSINESS USE OF HOME, RENTAL OF VACATION HOMES, ETC.

(a) GENERAL RULE.—Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an electing small business corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

(b) EXCEPTION FOR INTEREST, TAXES, CASUALTY LOSSES, ETC.—Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).

(c) EXCEPTIONS FOR CERTAIN BUSINESS OR RENTAL USE; LIMITATION ON DEDUCTIONS FOR SUCH USE.—

(1) CERTAIN BUSINESS USE.—Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis—

(A) as the taxpayer's principal place of business,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer.

(2) CERTAIN STORAGE USE.—Subsection (a) shall not apply to any item to the extent such item is allocable to space within the dwelling unit which is used on a regular basis as a storage unit for the inventory of the taxpayer held for use in the taxpayer's trade or business of selling products at retail or wholesale, but only if the dwelling unit is the sole fixed location of such trade or business.

(3) RENTAL USE.—Subsection (a) shall not apply to any item which is attributable to the rental of the dwelling unit or portion thereof (determined after the application of subsection (e)).

(4) USE IN PROVIDING DAY CARE SERVICES.—

(A) IN GENERAL.—Subsection (a) shall not apply to any item to the extent that such item is allocable to the use of any portion of the dwelling unit on a regular basis in the taxpayer's trade or business of providing day care services to individuals.

(B) LICENSING, ETC., REQUIREMENT.—Subparagraph (A) shall apply to items accruing for a period only if the owner or operator of the trade or business referred to in subparagraph (A)—

(i) has applied for (and such application has not been rejected),

(ii) has been granted (and such granting has not been revoked), or

(iii) is exempt from having,

a license, certification, registration, or approval as a day care center or as a family or group day care home under the provisions of any applicable State law. This subparagraph shall apply only to items accruing in periods beginning on or after the first day of the first month which begins more than 90 days after the date of the enactment of this subparagraph.

[(4)] (5) LIMITATION ON DEDUCTIONS.—In the case of a use described in paragraph (1) [or], (2), *or* (4) and in the case of a use described in paragraph (3) where the dwelling unit is used by the taxpayer during the taxable year as a residence, the deductions allowed under this chapter for the taxable year by reason of being attributed to such use shall not exceed the excess of—

(A) the gross income derived from such use for the taxable year, over

(B) the deductions allocable to such use which are allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was so used.

(d) USE AS RESIDENCE.—

(1) IN GENERAL.—For purposes of this section, a taxpayer uses a dwelling unit during the taxable year as a residence if he uses such unit (or portion thereof) for personal purposes for a number of days which exceeds the greater of—

(A) 14 days, or

(B) 10 percent of the number of days during such year for which such unit is rented at a fair rental.

For purposes of subparagraph (B), a unit shall not be treated as rented at a fair rental for any day for which it is used for personal purposes.

(2) PERSONAL USE OF UNIT.—For purposes of this section, the taxpayer shall be deemed to have used a dwelling unit for personal purposes for a day if, for any part of such day, the unit is used—

(A) for personal purposes by the taxpayer or any other person who has an interest in such unit, or by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person;

(B) by any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or

(C) by any individual (other than an employee with respect to whose use section 119 applies), unless for such day the dwelling unit is rented for a rental which, under the facts and circumstances, is fair rental.

VI. ADDITIONAL VIEWS OF HON. KEN HOLLAND

I am in basic accord with the position of the committee majority in the passage of this tax deduction for the business use of residences for day care services. I wish, however, to make clear my concern that in this action we have passed over a wonderful opportunity to create an incentive to the day care industry and to the several States that would enhance efforts to license and better control day care operations.

The "tax relief" we have provided is justified. However, I am troubled and concerned over the alarming number of questionable day care operations not subject to licensing in a number of States. In many instances where licensing is required, there exist negligible administrative controls and backlogs of applications. Although the measure as adopted moves in the direction of suggesting licensing of day care operations, it does not focus on the immediate problems in this industry. I am of the opinion that a deduction should be allowed only for those day care operations which have been licensed by the respective States. It is my hope that, where practical, incentives can be built into our tax laws and other laws relating to day care that will bring about stricter control over the operation of homes and centers caring for our children.

KEN HOLLAND.